

Module I

IRC section 145 - Qualified 501(c)(3) Bonds

Module I

IRC section 145 - Qualified 501(c)(3) Bonds

Overview

Introduction Module I completes the text's discussion of qualified private activity bonds by focusing on qualified 501(c)(3) bonds. As Exempt Organizations Specialists, you can expect to encounter these bonds during the course of a regular EO examination. Additionally, other agents who are conducting an examination of a 501(c)(3) organization may come across these bonds, and request your assistance with them.

Objectives At the end of this module, the student will be able to:

- Define a qualified 501(c)(3) bond as described in IRC section 145.
- Describe the requirements of the private business use test.
- Describe how unrelated trade or business activity affects the private business use test.
- Identify the rules for the private payment and security test.
- Define a qualified hospital bond.
- Determine if nonhospital bonds meet the \$150 million volume cap.
- Determine if bonds used for residential rental property are qualified 501(c)(3) bonds.
- Identify the private activity bond rules of other Code sections which apply to qualified 501(c)(3) bonds.

In this module This module contains the following topics:

| Topic | See Page |
|---|----------|
| Overview | I-1 |
| Introduction | I-2 |
| Section 1: Private Business Tests | I-4 |
| Section 2: \$150 Million Volume Cap for Nonhospital Bonds | I-14 |
| Section 3: Residential Rental Facilities | I-25 |
| Section 4: Other Applicable Private Activity Bond Rules | I-27 |
| Section 5: Audit Techniques | I-28 |
| Summary | I-30 |
| Class Exercises | I-31 |
| Case Study | I-33 |

Introduction

Definition of Qualified 501(c)(3) Bonds Qualified 501(c)(3) bonds are bonds issued under IRC section 145 to finance property OWNED BY:

- an organization described in IRC section 501(c)(3) (an “exempt organization”), OR
- a governmental unit.

Statutory provisions The specific requirements for qualified 501(c)(3) bonds are provided in IRC section 145.

Treas. Reg. section 1.145-2(a) provides that sections 1.141-0 through 1.141-15 of the regulations are applicable to bonds issued under IRC section 145(a).

Other requirements applicable to qualified private activity bonds that are also applicable to qualified 501(c)(3) bonds are provided in IRC sections 146-150.

Use of proceeds Under IRC section 145(a), ALL of the net proceeds of qualified 501(c)(3) bonds (bond proceeds less amount in the reasonably required reserve fund) must be used to finance property OWNED BY:

- an exempt organization, or
- a governmental unit.

Unlike exempt facility and small issue bonds, as long as used in an exempt organization’s exempt purposes, proceeds of qualified 501(c)(3) bonds may be used to provide working capital or intangible property for an exempt organization. Note though, that certain arbitrage rules specifically apply to bonds issued to finance working capital. **(See Treas. Reg. sections 1.148-1(c)(4), 1.148-2(e)(3), and 1.148-6(d)(3).)**

Borrower The borrower of qualified 501(c)(3) bonds must be an organization that has received a favorable letter from the Service stating that it is an organization described in IRC section 501(c)(3). The organization must maintain its exempt status as long as the bonds are outstanding.

You will learn more about the treatment of qualified 501(c)(3) bonds when the exempt status is revoked while the bonds are outstanding in Module L.

Continued on next page

Introduction, Continued

Private use tests

As with other types of qualified private activity bonds, qualified 501(c)(3) bonds already have some inherent private use - that of the exempt organization itself. It is this private use that differentiates these bonds from governmental bonds. However, IRC section 145 considers use by an exempt organization in its **related** activities as a “good use.”

The next section discusses the private business tests in detail.

Section 1

Private Business Tests

Overview

Introduction

When the private activity bond tests of IRC section 141 were discussed in Module D, you learned that in order to be a private activity bond, a bond must meet either:

- the private business tests, **OR**
- the private loan financing test.

Since over five percent of the proceeds would generally be loaned to the exempt organization, the private loan financing test will always be met, making these bonds private activity bonds from the outset. Remember, though, that the interest on private activity bonds can still be tax-exempt, if the bonds meet the special rules for specific types of **qualified** private activity bonds, including qualified 501(c)(3) bonds.

However, IRC section 145(a)(2) provides that in order for bonds to be considered qualified 501(c)(3) bonds, the bonds must NOT meet the private business use test AND the private security and payment test, as specified in IRC section 141(b).

For purposes of applying the private business tests under IRC section 141, an exempt organization using facilities financed with qualified 501(c)(3) bonds is treated as a governmental unit. This means that use of the bond-financed facility by a exempt organization (in related activities), or by a governmental unit, is generally NOT considered private use.

In addition, IRC section 145(a)(2)(B) provides that **five percent** is substituted for the **ten percent** limit in IRC section 141(b). Also **net proceeds** is substituted for **proceeds**.

Continued on next page

Overview, Continued

Private Business Use Test

To be considered qualified 501(c)(3) bonds, no more than five percent of the net proceeds of the bond issue may be used for any private business use. This five percent refers to use by a private party OTHER THAN an exempt organization or a governmental unit. Use by an exempt organization, other than the borrower, which is unrelated trade or business use under IRC section 513, is considered private use.

According to Treas. Reg. section 1.145-2(c)(2), issuance costs are included in this five percent private business use.

Example

Assume that Charity A borrows \$100M of bond proceeds from City B in order to build a hospital. The ownership and private business use tests are calculated as follows:

| | |
|--------------|--|
| Proceeds | \$100M |
| Reserve fund | < 10M > |
| Net Proceeds | \$ 90M (Hospital must be 100 percent owned by Charity A or City B) |
| | <u>x.05</u> |
| | \$ 4.5M (Can be used for "bad costs.") |
| | < 2 M > (2 percent of \$100M allocated to issuance costs) |
| | \$ 2.5M (Remaining amounts permitted for private use) |

Private Security and Payment Test

To be considered qualified 501(c)(3) bonds, no more than five percent of the payment of the debt service on the bonds may be directly or indirectly:

- secured by an interest in property used or to be used for a private business use, OR
- secured by payments in respect of such property, OR
- to be derived from payments in respect of property, or borrowed money, to be used in a private business.

Again, remember that interest and principal payments made by the exempt organization are not included, because the exempt organization is treated as a governmental unit.

Continued on next page

Overview, Continued

Election out IRC section 145(e) provides that issuers may elect NOT to treat bonds as qualified 501(c)(3) bonds if:

- the bonds are exempt facility or qualified redevelopment bonds, **AND**
 - IRC section 146 applies to the bonds.
-

In this section This section contains the following topics:

| Topic | See Page |
|---|-----------------|
| Overview | I-4 |
| Private Business Use Test | I-7 |
| Unrelated Trade or Business Use | I-9 |
| Management Service Contracts | I-10 |
| Research Agreements | I-11 |
| Private Payment and Private Security Test | I-12 |
| Mixed Use and Multipurpose Facilities | I-13 |

Private Business Use Test

95 Percent Test At least 95 of the net proceeds of the bonds must be used to finance facilities owned and used by an exempt organization or a governmental unit.

The use of the bond-financed facilities by the exempt owners must not be an unrelated trade or business. The unrelated trade or business is determined by applying IRC section 513(a).

Note ***This test works in conjunction with the requirement that all of the net proceeds of the bonds must be used to finance facilities owned by an exempt organization or a governmental unit.***

The rules regarding private use are the same for qualified 501(c)(3) bonds as for governmental bonds and are more fully described in Module D. (See also section 1.141-3 of the regulations.)

Net Proceeds Net proceeds are proceeds received from the sale of the bonds less any amounts deposited into the reasonably required reserve and replacement fund.

Examples

Example 1

City X issues and sells \$5 million principal amount of bonds at par. It loans the \$5 million to Corporation Y, an exempt organization, to be used to construct a nursing home. Corporation Y deposits \$450,000 in a reasonably required debt service reserve fund. The remaining \$4,550,000 are net proceeds.

Example 2

Same as Example 1, except, Corporation Y uses \$500,000 of the proceeds to construct an office building adjacent to the nursing home and leases the building to Partnership Z for a term of 20 years. Partnership Z will provide accounting services to Corporation Y. The bonds will not be qualified 501(c)(3) bonds because not all of the net proceeds were used to finance property owned and used by an exempt organization.

Continued on next page

Private Business Use Test, Continued

Examples, continued

Example 3

Same as Example 1, except, Corporation Y leases 2 percent of the space in the nursing home to Partnership Z for the entire term of the bonds. The amount of bond proceeds used to construct this space was \$106,500. Partnership Z will have its equipment and employees in this space and will provide accounting services to Corporation Y. Partnership Z will pay rent at fair market value and there is no relationship between Corporation Y and Partnership Z.

The use of the space by Partnership Z will not violate the 95 percent private use test because at least 95 percent of the net proceeds were used to finance a facility owned and used by an exempt organization. In addition, all of the net proceeds of the bonds were used to finance a facility owned by an exempt organization. Therefore, the bonds will be qualified 501(c)(3) bonds.

Example 4

Example 4

City X issues \$12 million principal amount of bonds and loans the proceeds to Corporation A, an exempt organization. Corporation A will use the proceeds to purchase an existing multi-family residential rental facility. Corporation A deposits \$900,000 in a reasonably required reserve fund and uses \$11,100,000 to acquire the facility. A portion of the facility has always been rented by City X and used to provide services to the residents of the community, including the facility. City X will continue to rent this portion after Corporation A acquires the facility.

Because all of the net proceeds are used to acquire a facility owned by an exempt organization and used by an exempt organization and a governmental unit, the bonds are qualified 501(c)(3) bonds. The rental by City X will not disqualify the bonds.

Use by General Public

Use of bond financed facilities by private persons in their trade or business may be treated as general public use and not private business use. To be considered use by the general public, the property must be reasonably available for use on the same basis by natural persons not engaged in a trade or business. **(See Treas. Reg. section 1.141-3(c).)**

Note

The rules regarding general public use are the same for qualified 501(c)(3) bonds as for governmental bonds and are more fully described in Module D. (See also Treas. Reg. section 1.141-3(c))

Unrelated Trade or Business Use

General

Use of bond proceeds or bond-financed facilities by an exempt organization in an unrelated trade or business activity is considered private business use. This unrelated use is counted against the permissible 5 percent private business use. (See IRC section 145(a)(2)(A).)

Whether an activity is an unrelated trade or business activity is determined in accordance with IRC section 513.

Note

Although the use of a bond financed property may not be considered an unrelated business use under IRC section 513, it may be private use for purposes of IRC section 145. For example, a medical office building connected to the hospital and used by physicians which are not employees of the hospital but practice at the hospital may not be considered to be unrelated use under section 513. However, such use may be private use for purposes of the 95 percent test.

Example 1

Authority X issues \$15 million principal amount of bonds and loans the proceeds to Corporation M, an exempt organization, to construct a clinic. After the clinic has been constructed, Corporation M realizes that it has too much space and rents 10 percent of the space in the clinic to a sole proprietor who will operate a pharmacy and a flower shop in the rented space. Even if the rental of the space by Corporation M is considered not an unrelated trade or business under IRC section 513, the bonds will not be qualified 501(c)(3) bonds. This is because the space is used in a trade or business of a private party.

Example 2

Same as Example 1, except, that Corporation M rents the space to Corporation Z, an exempt organization. If the use by Corporation Z of the space is considered an unrelated trade or business under IRC section 513 with respect to Corporation M, the bonds will not be qualified 501(c)(3) bonds.

Management Service Contracts

Definition Contracts between the exempt organization and certain private parties pursuant to which the private parties provide services to the exempt organization may result in private business use. These contracts are known as “management contracts. (See **Treas. Reg. section 1.141-3(b)(4)(i).**)

Certain arrangements are generally not treated as management contracts resulting in private business use. (See **Treas. Reg. section 1.141-3(b)(4)(iii) and section 2.01(7) of Rev. Proc. 97-13, 1997-1 C.B. 632.**)

Safe Harbors The Service has provided safe harbors regarding management service contracts between a for-profit entity and an exempt organization where the service is provided in connection with a bond-financed facility.

Prior to March 15, 1993, Rev. Proc. 82-14, 1982-1 CB 459 and Rev. Proc. 82-15, 1982-1 CB 461 provided guidelines for management service contracts.

Rev. Proc. 93-19, 1993-1 CB 526 sets forth the safe harbors for management service contracts entered into, materially modified, or extended after March 15, 1993. Rev. Proc. 93-19 rendered Rev. Procs. 82-14 and 82-15 obsolete.

For service contracts executed, materially modified, or amended on or after May 16, 1997, the safe harbors are provided in Rev. Proc. 97-13, 1997-1 C.B. 632. Rev. Proc. 97-13 supersedes Rev. Proc. 93-19.

Rev. Proc. 93-19 and Rev. Proc. 97-13 are included as Exhibit I-1 and I-2 to Module I.

Research Agreements

**Rev. Proc.
97-14**

Certain agreements with respect to bond financed facilities under which a private entity sponsors research by an exempt organization may result in private business use. **(See Treas. Reg. section 1.141-3(b)(6).)**

Private business use occurs if the sponsor is treated as the lessee or owner of the bond financed property for federal income tax purposes.

Rev. Proc. 97-14, 1997-1 C.B. 634, provides safe harbors for research agreements. Rev. Proc. 97-14 is effective for any research agreement entered into on or after May 16, 1997.

Rev. Proc. 97-14 is attached as Exhibit I-3 to Module I.

Private Payment and Private Security Test

General

To be considered qualified 501(c)(3) bonds, no more than five percent of the payment of debt service on the bonds, directly or indirectly:

- may be made from payments in respect of property, or borrowed money, used or to be used for a private business use, OR
- secured by any interest in property used or to be used by a private party or in payments in respect of such property.

The security for, and payment of debt service on the bonds is determined from the terms of the bond documents and any underlying arrangements.

Note

The rules regarding the private security and private payment test are the same for qualified 501(c)(3) bonds as for governmental bonds and are more fully described in Module D. (See also Treas. Reg. section 1.141-4).

Mixed Use and Multipurpose Facilities

Definition Mixed use or multipurpose facilities are facilities that have multiple users, such as an exempt organization and a private entity.

Allocations A mixed use or multipurpose facility may be financed in part with qualified 501(c)(3) bonds. The portion that is bond financed must be used by the exempt organization in its exempt purposes or by a governmental unit.

The portion used by the private entity must be financed with taxable financing or sources other than bond proceeds.

The allocations between the different uses of the facility must be made in proportion to the benefits derived, directly or indirectly, by the various users of the facility.

The allocations of the bond proceeds and other sources of funds, and the use of the facility by various parties, must be reasonable and consistently applied.

Section 2

\$150 Million Volume Cap for Nonhospital Bonds

Overview

Introduction Qualified 501(c)(3) bonds are NOT subject to the state volume limits of IRC section 146. However, until August 5, 1997, IRC section 145(b) limited the aggregate outstanding face amount of qualified 501(c)(3) bonds that may be allocated to an exempt organization, which is a test-period beneficiary, to \$150 million.

If the bonds are qualified hospital bonds, this rule does NOT apply. Therefore, the first determination to be made is whether the bonds are hospital or nonhospital bonds.

In this section This section contains the following topics:

| Topic | See Page |
|---|----------|
| Overview | I-14 |
| Nonhospital and Qualified Hospital Bonds | I-15 |
| Bonds Taken Into Account For the \$150 Million Limitation | I-17 |
| Test-Period Beneficiary | I-19 |
| Aggregation Rule | I-20 |
| Bonds Allocated to Test-Period Beneficiary | I-21 |
| Refunding Bonds | I-22 |
| Loss of Tax Exemption | I-24 |

Nonhospital and Qualified Hospital Bonds

Note

The rules stated below apply to qualified 501(c)(3) bonds issued:

- before August 5, 1997;
 - to refund qualified 501(c)(3) bonds issued before August 5, 1997; OR
 - after August 5, 1997 which do NOT meet the requirements of Section 222 of the Taxpayer Relief Act of 1997, described below.
-

Nonhospital Bonds

Nonhospital bonds are all qualified 501(c)(3) bonds that are not qualified hospital bonds.

Qualified Hospital Bonds

The \$150 million limitation does NOT apply to qualified hospital bonds.

At least 95 percent of the proceeds of the bonds are used with respect to a hospital. (See **IRC section 145(c)**)

Hospital

A hospital is a facility that:

- is accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO), or is accredited or approved by a program of the qualified governmental unit in which such institution is located. The Secretary of Health and Human Services must find that the accreditation or comparable approval standards of the governmental unit are essentially equivalent to JCAHO;
 - is primarily used to provide, by or under the supervision of physicians, to in-patients diagnostic services and therapeutic services for medical diagnosis, treatment and care for the injured, disabled or sick persons (including the mentally ill);
 - has a requirement that every patient be under the care and supervision of a physician; AND
 - provides 24-hour nursing services rendered or supervised by a registered professional nurse and has a licensed practical nurse or a registered nurse on duty at all times.
-

Continued on next page

Nonhospital and Qualified Hospital Bonds, Continued

**Hospital,
continued**

Rest or nursing homes, day care centers, medical school facilities, research laboratories, and ambulatory care facilities are NOT hospitals.

(See HR Rep No 426, 99th Cong, 1st Session, December 7, 1985, pages 540 and 541. AND HR Rep No 841, 99th Cong., 2d Session., September 18, 1986, pages 725 and 726.)

**Repeal of
Limitation**

Section 222 of the Taxpayer Relief Act of 1997 amended IRC section 145(b) by repealing the \$150 million limitation on nonhospital bonds for certain financings.

Capital expenditures incurred by a 501(c)(3) organization after August 5, 1997, may be financed with proceeds of tax-exempt bonds without regard to the \$150 million limitation in IRC section 145(b).

Bonds Taken Into Account for the \$150 Million Limitation

General

IRC section 145(b)(2)(B) and (C) provide that for purposes of applying the \$150 million limitation to a test-period beneficiary, the aggregate outstanding amount of the following bonds is included:

- any qualified nonhospital bonds,
- any bonds outstanding on August 16, 1986, that are not private activity bonds because they were issued before such date, if such bonds would have been industrial development bonds had the 1954 Code not treated exempt organizations as governmental entities, and
- at least 10 percent of the net proceeds of such bonds must have been used for nonhospital purposes, AND
- the bonds were not exempt facility, industrial park or small issue bonds under the 1954 Code.

(See HR Rep No. 426, 99th Cong, 1st session, December 7, 1985, pages 538-540 and HR Rep. No. 841, 99th Cong., 2d Sess., September 18, 1986 pages II-726-728.)

Note

Special rules apply to bonds that have been refunded. (See "Refunding Bonds" below.)

Example

Corporation X, a 501(c)(3) organization plans to borrow the entire \$15 million principal amount of qualified 501(c)(3) bonds to be issued in June 1997. In 1994, Corporation X borrowed \$75 million principal amount of bonds to construct a new wing of a hospital. In 1993, Corporation X borrowed \$32 million principal amount of bonds to construct a retirement facility. In 1987, Corporation X borrowed \$16 million principal amount of bonds to acquire three skilled-care nursing facilities. In 1985, Corporation X borrowed \$20 million principal amount of bonds to acquire six nursing homes. Although they could have been, the 1985 bonds were not issued under section 103(b)(2) of the 1954 Code, which governed industrial development bonds. All of the bonds are currently outstanding.

In determining the bonds to be taken into account for purposes of IRC section 145(b)(2)(B), Corporation X will include the 1997 bonds, the 1993 bonds, the 1987 bonds and the 1985 bonds.

Continued on next page

Bonds Taken Into Account for the \$150 Million Limitation, Continued

**Aggregate
Outstanding
Amount**

The aggregate outstanding face amount is determined by the issue price of the bonds. **(See PLR 9431007.)** In addition, Footnote 135 of the Blue Book indicates Congress' intent that premiums and discounts are not to be used for purposes of calculating the true principal amount of an issue.

Test-Period Beneficiary

| | |
|--------------------|--|
| Definition | A test-period beneficiary is any exempt organization who is: <ul style="list-style-type: none">• an owner,• a principal user, OR• a related person to an owner or principal user of the bond financed facilities during the test-period. |
| Test-Period | The test-period is a three-year period beginning on the later of: <ul style="list-style-type: none">• the date the financed facility is placed in service, OR• the date the bonds are issued. |
| Note | <i>The rules applicable to the \$40 million limitation under IRC section 144(a)(10)(D) are applied for purposes of determining test-period, test-period beneficiary, and placed in service.</i> |

Aggregation Rule

**Common
Management or
Control**

IRC section 145(b)(3) provides that for purposes of determining the \$150 million limitation, two or more organizations under common management or control shall be treated as one organization.

HR Rep No 426, 99th Cong, 1st session, December 7, 1985, pages 539 and 540 states that related persons include related entities engaged in unrelated trades or businesses. An exempt organization is treated as related to any other person if it owns 50 percent or more of either the capital interests or profit interests in the other.

The House Report also states that any exempt organization will be treated as related to another person if the two have (a) significant common purposes and substantial common membership, or (b) directly or indirectly, substantial common direction. For example, a local chapter of a national organization is treated as related to the national organization.

In addition to the above, "related party" is defined in Treas. Reg. section 1.150-1(b), and "controlled group" is defined in Treas. Reg. section 1.150-1(e).

Bonds Allocated to Test-Period Beneficiary

General

The amount of bonds allocated to any test-period beneficiary is the amount that bears the same relationship to the entire face amount of bonds as the portion of the bond financed facility used by the beneficiary bears to the entire facility.

HR Rep No 426, 99th Cong., 1st Session, December 7, 1985, page 540 provides that, once a portion of an issue is allocated to an exempt organization, that allocation remains in effect as long as the bonds are outstanding. This is true even if the organization no longer owns or uses the property financed with the bonds. Similarly, the fact that a person stops being related to an owner or principal user of the property after an allocation is made does not alter the allocation to that person as long as the bonds are outstanding.

Note

The rules applicable to the \$40 million limitation for qualified small issue bonds under subsections (C), (D), and (E) of IRC section 144(a)(10) apply to qualified 501(c)(3) bonds for the purposes of applying the \$150 million limitation. (See subsection titled "\$40 Million Limitation" under "QUALIFIED SMALL ISSUE BONDS" of Module G of this text.)

Refunding Bonds

General

In determining whether the \$150 million limitation has been exceeded, bonds that are redeemed by a later issue (other than advance refunding bonds) are not taken into account. (See IRC section 145(b)(2)(A)(ii)).

At page 1186 the Blue Book provides that, in the case of current refundings, the refunding bonds are not taken into account (even if the beneficiary of the bonds has more than \$150 million in bonds outstanding) if:

- (1) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, and
- (2)(a) the weighted average maturity of the refunding bonds does not exceed 120 percent of the weighted average reasonable expected economic life of the facilities financed with the refunded bonds, or
- (2)(b) the last-maturing bond in the refunding issue matures no later than 17 years after the issue date of the refunded bonds.

Transitional Rule

Advance refunding bonds are counted in determining whether the \$150 million limitation is exceeded. However, the Blue Book states that under a special transitional rule, one advance refunding after March 14, 1986, of a bond issued before January 1, 1986, is permitted even if this refunding results in the exempt organization having more than \$150 million of outstanding bonds allocated to it.

However, such advance refunding bonds are counted as outstanding bonds for purposes of determining whether subsequent new money or advance refunding bonds may be issued.

Example 1

On April 7, 1991, Corporation Y, a 501(c)(3) organization is a beneficiary of \$120 million principal amount of nonhospital bonds. On this date, Corporation Y wants to borrow \$60 million face amount of advance refunding bond proceeds to advance refund bonds issued on December 12, 1985. These advance refunding bonds will not be included in calculating the \$150 million limitation allocated to Corporation Y.

Continued on next page

Refunding Bonds, Continued

**Transitional
Rule, continued**

Example 2

On August 15, 1987, Corporation Y borrows \$20 million face amount of bonds to construct a nursing home. On May 10, 1992, Corporation Y wants to advance refund the 1987 bonds by borrowing \$19.7 million face amount of bonds. The 1987 bonds and the 1992 refunding bonds will be included in the calculation of the \$150 million limitation allocated to Corporation Y.

Loss of Tax Exemption

General

If an issue of qualified 501(c)(3) bonds causes the \$150 million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable.

If the \$150 million limitation is violated with respect to an issue by a change of owners or principal users of bond financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued.

(See HR Rep No 426, 99th Cong, 1st Session, December 7, 1985, page 540).

Section 3

Residential Rental Facilities

Overview

General Rule IRC section 145(d)(1) provides that proceeds of qualified 501(c)(3) bonds may not be used, directly or indirectly, to finance residential rental property for family units.

Exceptions IRC section 145(d)(2) excepts from the general rule the following:

- if the first use of the bond financed facility is as a residential rental property for family units, or
- the facility is a qualified residential rental project, as defined in IRC section 142(d), or
- the bond financed property will be substantially rehabilitated beginning within the 2-year period ending 1 year after the date of acquisition of the property.

First Use Rule IRC section 145(d)(3)(A) permits residential rental facilities to be treated as if the first use of it is residential rental even if that were not the case if:

- the first use of the facility was pursuant to taxable financing,
- at the time of the taxable financing there was reasonable expectation that the taxable financing would be replaced with tax-exempt bonds, and
- the taxable financing is replaced with tax-exempt financing within a reasonable period after the taxable financing is provided.

Special Rule Regarding First Use In addition to the above, IRC section 145(d)(3)(B) provides that if, at the time of the first use of the property, there was no operating state or local program permitting use of tax-exempt bonds to finance a residential rental facility, the first time a property may be financed with tax-exempt bonds is treated as first use of the property.

Continued on next page

Residential Rental Facilities, Continued

Special Rule Regarding First Use, continued

Example

In 1987 Corporation X, an exempt organization, wanted to acquire an existing residential rental project located in County A. County A's local ordinance prohibited use of tax-exempt bonds to finance residential rental units. Corporation X acquired the facility with a taxable loan from a bank. In 1990, County A realized the increased need for low-income housing in its jurisdiction and amended its ordinance to permit issuance of tax-exempt bonds and established a housing authority to issue such bonds.

In 1991, Corporation X requested the housing authority to issue bonds, the proceeds of which were to be used to refinance the bank loan by Corporation X.

Although Corporation X already owns the facility and has been operating it, after the bond financing, the use by Corporation X will be considered first use of the facility.

Qualified Residential Rental Project

A bond issue may be a qualified 501(c)(3) bond issued to acquire a residential rental project, if the residential rental project meets the requirements for a “qualified residential rental project” under IRC section 142(d).

IRC section 142(d) also gives the requirements for qualified residential rental projects with respect to exempt facility bonds, and these requirements are described under the subsection titled, "Qualified Residential Rental Projects" in Module E, Section 5 of this text.

Substantial Rehabilitation

Rules under IRC section 47(c)(1)(C) are used to determine if the project has been substantially rehabilitated.

IRC section 47(c)(1)(C) provides that the qualified rehabilitation expenditures during the specified two-year period must exceed the greater of the adjusted basis of the project and its structural components or \$5,000. The Secretary may extend the two-year period in section 47(c)(1)(C)(i) where appropriate due to circumstances not within the control of the owner.

Section 4

Other Applicable Private Activity Bond Rules

**Applicable
Rules**

The following private activity bond rules are applicable to qualified 501(c)(3) bonds. These rules are discussed in other modules of this text.

- IRC section 147(b)(1) places a limit on the average maturity of qualified 501(c)(3) bonds.
 - IRC section 147(b)(4) provides special rules for qualified 501(c)(3) bonds, the proceeds of which are borrowed by two or more unrelated exempt organizations or governmental units.
 - IRC section 147(e) prohibits the use of qualified 501(c)(3) bonds to finance certain facilities.
 - The notice and public approval requirement of IRC section 147(f) is applicable to qualified 501(c)(3) bonds.
 - The limitation on costs of issuance under IRC section 147(g) is applicable to qualified 501(c)(3) bonds.
 - The arbitrage and rebate rules of IRC section 148 apply to these bonds.
 - Qualified 501(c)(3) bonds, like governmental bonds, may be advance refunded. IRC section 149(d) provides the rules regarding advance refundings.
 - The other applicable provisions of IRC section 149 also apply to these bonds.
 - IRC section 150(b)(3) provides rules regarding the change in use of a facility financed with qualified 501(c)(3) bonds which continues to be owned by an exempt organization after the change.
 - IRC section 150(c) contains exceptions to the general rule in IRC section 150(b)(3).
-

Section 5

Auditing Techniques

Overview

| | |
|---|--|
| General items | <p>Review records of issuer/conduit borrower to determine if private business use and private payments/security tests have been met. Meeting the tests causes the bonds to be unqualified and taxable.</p> <p>Unrelated trade or business use is considered a private activity.</p> <p>Review contracts, agreements, and sources of revenue to disclose payments from private users.</p> <p>Review in-house publications to disclose private activities.</p> <p>Tour the facilities looking for private use.</p> <p>The allocation for partial use is similar to UBIT between related and unrelated use.</p> <p>Remember that only 5 percent private business use and payment/security makes this an unqualified 501(c)(3) bond. Both private use and the private payment/security tests must be met in order to have an unqualified bond. Meeting only one test does not make the interest on the bond taxable.</p> |
| IRC section 145(b) - \$150 Million Cap | <p>For bonds issued before August 5, 1997, review all non-hospital bonds issued and outstanding by the conduit borrower and its related entities over a three-year period.</p> <p>The rules here are similar to those under IRC section 144(a)(10) with regard to the \$40 million limitation.</p> <p>Review conduit borrower's records such as:</p> <ul style="list-style-type: none">• liability records,• CPA annual reports,• listing of all issued and outstanding bonds from all related entities. |

Continued on next page

Overview, Continued

Use of CPA Annual Report

You have requested a list of all the issued and outstanding bonds of the conduit borrower and its related entities. You want to determine if the bonds exceeded the \$150 million limit. Part of your regular audit techniques are to request a copy of the annual CPA report for the conduit borrower. While reviewing the report's liability section you noticed an older, but still outstanding bond. This bond was not part of the list that the conduit borrower had given to you.

Summary

Review of Module I

Module I completes the text's discussion of qualified private activity bonds by discussing qualified 501(c)(3) bonds as described in IRC section 145.

Treas. Reg. sections 1.145-0 through 1.145-2 also provide rules for these bonds, but generally state that the private activity bond rules under Treas. Reg. sections 1.141-0 through 141.15 apply to qualified 501(c)(3) bonds.

Specific requirements of qualified 501(c)(3) bonds are:

- All of the net proceeds must be used to finance property OWNED BY an exempt organization or a governmental unit.
- Use by a 501(c)(3) organization in its related activities is treated as governmental use with respect to the private business tests.
- The bonds must NOT meet the private business use test AND the private security and payment test, using **five percent** instead of **ten percent**.
- Use of bond proceeds or bond-financed facilities by an exempt organization in an unrelated trade or business activity is considered private business use.
- Qualified 501(c)(3) bonds that are not qualified hospital bonds may be subject to a \$150 million volume cap.
- With certain exceptions, the proceeds of qualified 501(c)(3) bonds may not be used to finance residential rental property for family units.
- Qualified 501(c)(3) bonds are also subject to the general private activity bond rules provided by IRC sections 147 through 150.

Preview of Module J

Throughout the text's discussion of the various types of qualified private activity bonds, there have been references to other applicable private activity bond rules found in other sections of the Code. Modules J and K introduce you to some of these rules. Module J discusses the volume cap under IRC section 146, while Module K covers the requirements of IRC section 147. Generally, these rules govern all types of qualified private activity bonds. There are, of course, exceptions, and these will be pointed out in the text.

Class Exercises

Exercise 1

City A issues \$10 million principal amount of bonds and lends the proceeds to Corporation B, an exempt organization. Corporation B owns and operates a hospital with an adjacent medical office building, which is used by physicians in their private practice. The corporation plans to use the proceeds to construct a new parking facility. The facility will be adjacent to the hospital and medical office building. The facility will consist of three levels:

- **level one** will be restricted for use by the patrons of the medical office building,
- **levels two and three** will be used exclusively by hospital employees.

Debt service will be paid from parking revenues.

Question 1: Will the operation of the parking facility be considered private use?

Question 2: How will the parking facility affect the bond issue?

Continued on next page

Class Exercises, Continued

Exercise 2 On June 1, 1997, Corporation Z and Corporation W, both of which are exempt organizations, executed joint operating agreement. The bond history of Corporation Z and Corporation W is shown below. Indicate the amount of the prior bonds which should be allocated to Corporation Z and Corporation W for purposes of the \$150M cap.

| Issuance Date | Outstanding Amount on June 1, 1997 | Borrower | Additional Information | Placed in Service Date |
|----------------------|---|-----------------|---------------------------------------|-------------------------------|
| January 1, 1994 | \$35M | Corporation Z | construction of a retirement facility | May 7, 1994 |
| July 1, 1996 | \$40M | Corporation Z | construction of a retirement facility | Feb 6, 1997 |
| March 1, 1997 | \$65M | Corporation Z | renovations to a nursing home | April 15, 1997 |
| May 1, 1997 | \$15M | Corporation W | medical research facility | May 1, 1997 |

| Allocated to Corporation Z | Allocated to Corporation W |
|-----------------------------------|-----------------------------------|
| | |
| | |
| | |
| | |
| | |
| | |

Case Study

Scenario

Hospital H (“H”) is an organization described in IRC section 501(c)(3). H is located in City X. In 1994, H borrowed proceeds of \$150,000,000 principal amount of the Industrial Development Authority of City X (the “IDA”) Series 1994 Bonds (the “Bonds.”) Portions of the proceeds of the Bonds were used by H to add a new wing which contained additional patient rooms, surgery rooms, and nurses stations, etc for its growing obstetrics and pediatrics patients. A portion of the proceeds of the Bonds was used to rehabilitate the lobby area of H which was initially constructed in 1975.

The Bonds were issued as fixed rate bonds and were insured by Corporation X. H paid \$1,000,000 as premium to Corporation X at the time of issuance of the Bonds. Law Firm A gave the opinion that the interest on the Bonds was exempt from federal income taxation and Law Firm B represented H in the transaction. Law Firms A and B received \$65,000 and \$45,000 from the proceeds of the Bonds in connection with the transaction.

H, at the request of IDA retained Corporation Y to sell the Bonds to the public. Corporation Y received 1 percent of the original principal amount of the Bonds as its fee. Out of that amount, it paid Law firm C, its counsel, to provide advice regarding federal and state securities laws.

The IDA had retained Corporation Z to provide financial advice regarding bond issuances. As a condition for issuing the Bonds, H was required to pay Corporation Z \$30,000 from the proceeds of the Bonds.

As a condition for issuing its insurance policy, Corporation X required that H obtain rating letters on the Bonds from the two rating agencies. The rating agencies received \$15,000 each.

H also paid, in addition to Corporation Y’s fees, \$25,000 to a printer to print the offering statements.

When the Bonds were issued, H had already finished the rehabilitation on the lobby which cost \$45,000. H had finished that in July 1993. The lobby area includes a gift shop, a pharmacy, reception area, and waiting area.

The construction of the new wing was completed in 1996. This wing includes a floor that has physician office space.

Continued on next page

Case Study, Continued

Questions for discussion

The agent auditing the bonds must determine the following:

- Who were the parties to the transaction?
 - What was the cost of issuance of the Bonds? did the costs of issuance meet the requirements under IRC section 147(g)?
 - Was there a reserve fund established for the bonds?
 - Did the Bond issue meet the requirement that 95 percent of the net proceeds of the Bonds were used for exempt purposes?
 - What must the agent do to determine the 95 percent net proceeds test?
 - Was any portion of the proceeds used in private use or use which is not related to the exempt purposes of the Hospital?
 - Is use by a gift shop and pharmacy, in and of itself, unrelated to the Hospital's exempt purpose?
 - Is use of one floor of the wing as physician offices private use?
 - Should the agent determine the relationship between the physicians the Hospital, i.e. are they employees of the Hospital or just have visiting privileges?
 - Is the use by the physicians part of a physician practice group?
 - If the gift shop and pharmacy are considered related to the Hospital's exempt purpose, should the agent look further and see if these facilities are managed by a private operator?
 - If these facilities are managed by a private operator, do the contracts meet the private use safe harbor?
 - If they do not, does the cumulative private use of Bond proceeds and payment of debt service on the bonds exceed 5 percent?
 - How should the payment or security test be measured?
 - In determining the 5 percent private use, has the agent included costs of issuance (even if it was less than 2 percent of the proceeds of the bonds?)
 - Assume the Hospital funded a reserve fund with proceeds of the bonds in an amount equal to \$12,000,000. How does this information change the analysis under the 95 percent net proceeds test for exempt purposes?
 - The Hospital used \$45,000,000 to pay itself for a prior expenditure. The agent should determine whether this was a proper expenditure under Treas. Reg. section 1.150-2. (These provisions will be discussed later and this portion of the exercise should be conducted at that time.)
 - Finally, what would happen if the agent, during the course of the audit, discovered that due to private inurement, the Hospital may no longer qualify as an organization described under section 501(c)(3)?
-